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In the Supreme Court of the United States

OCTOBER TERM, 1979

UNITED STATES OF AMERICA, PETITIONER

v.

ELWOOD SWANK AND RITA SWANK

UNITED STATES OF AMERICA, PETITIONER

v.

BLACK HAWK COAL CORPORATION, INC.

UNITED STATES OF AMERICA, PETITIONER

v.

BULL RUN MINING CO., INC.

ON WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES

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BRIEF FOR THE UNITED STATES

QUESTION PRESENTED

Whether a provision in a mineral lease permitting the lessor to terminate the lease on 30 days' notice without cause deprives the lessee of an economic interest in the minerals in place so that the lessee is not entitled to a depletion deduction under Sections 611(a) and 613 of the Internal Revenue Code of 1954.

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OPINION BELOW

The opinion of the Court of Claims (Pet. App. 1a–16a) is reported at 602 F.2d 348.

JURISDICTION

The judgment of the Court of Claims was entered on November 30, 1979, in *Swank* (Pet. App. 17a–18a). The judgments of that court were entered on December 7, 1979, in *Bull Run Mining Co.* and *Black Hawk Coal Corporation* (Pet. App. 19a–22a). By order dated February 21, 1980, the Chief Justice extended the time within which to file a petition for a writ of certiorari to and including March 29, 1980. The petition was filed on March 27, 1980, and was granted on May 12, 1980 (J.A. 117a). The jurisdiction of this Court rests on 28 U.S.C. 1255.

STATUTE AND REGULATION INVOLVED

The pertinent provisions of Sections 611 and 613 of the Internal Revenue Code of 1954 (26 U.S.C.) and of Treasury Regulations on Income Tax, Section 1.611–1 (26 C.F.R.), are set forth in the Appendix, *infra*, 1a–2a.

STATEMENT

1. a. *Swank*. During 1966–1967, respondent Swank[1] was engaged in mining anthracite coal on various tracts located in Northumberland County, Pennsylvania. At this time, Northumberland County owned more than 17,500 acres of land in the county which it had acquired at various tax sales (J.A. 52a–53a). Swank had leased one of these

[1] References to respondent or Swank are to Elwood Swank. Rita Swank is a party solely because she filed joined federal income tax returns with her husband for the years in issue.

tracts from Northumberland County under a lease agreement dated October 24, 1964 (J.A. 52a).

Respondent engaged in deep mining operations on this property until May 1968. At that time, heavy rains precipitated a mountain slide which forced him to close the mine. Respondent's deep mining methods included the excavation of shafts through the overburden, the extraction of coal by means of explosives, picks and shovels, the transportation of the coal to the surface, and the conveyance of the coal to Swank's breakers where it was cleaned and sorted for sale to the general public (J.A. 52a).

During this period respondent leased a second tract of land from the County. Under the terms of a lease agreement dated July 25, 1966, respondent agreed to engage in strip mining operations on 133 acres owned by the County. He strip mined on this tract in both 1966 and 1967. Respondent's strip mining operations involved the removal of the overburden by a power shovel and the removal of the then-exposed coal seam by power equipment. The coal was then transported by truck to respondent's breakers, where it was cleaned and sorted for sale. The tract in question had previously been leased by the County to Edward Gusick. After respondent purchased certain equipment and leasehold improvements from Gusick for $12,085, the County cancelled Gusick's lease and issued a new lease to respondent.[2]

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[2]The Court of Claims found (J.A. 52a) that respondent had "bought out" Gusick's interest for $12,085, "including the assumption of remaining payments of $5,085.50 on generating equipment, and the balance for Gusick's existing excavation on the property." According to the stipulation of facts, however, Swank capitalized only $1,000 into an account covering purchased excavations. The bulk of the investment was apparently allocated to various items of mining equipment.

Pursuant to both of the leases, respondent was authorized to mine coal on lands owned by the County in exchange for a royalty of 35 cents per gross ton of coal removed.[3] Respondent could sell the coal to whomever he pleased at whatever price he could obtain (J.A. 24a, 33a, 54a). Both leases contained provisions for automatic termination if either (1) the County sold the lands; (2) the tax delinquent former owners redeemed the lands; (3) the lessee failed to mine and remove coal for 30 consecutive days absent abnormal conditions; or (4) the lessee failed to comply with the terms of the lease agreement (J.A. 26a–27a, 30a–31a, 35a–37a, 39a–40a). Moreover, each lease provided, in accordance with the County's practice with respect to all leases negotiated between January 1, 1956 and May 31, 1969, that the lessor could "terminate this agreement completely and fully without liability upon it or any further recourse against it, upon thirty days written notice given to MINER * * *" (J.A. 27a, 37a).[4]

On its federal income tax returns for 1966 and 1967, respondent claimed deductions of $41,371.24 and $15,204.32, respectively, for depletion of coal resources covered by his leases with the County of Northumberland (J.A. 8a–9a).

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[3] Pursuant to the lease agreements, respondent paid the County royalties of $7,545.10 and $6,854.05 during 1966 and 1967, respectively (J.A. 53a). Although the County reserved the right to increase the royalties as much as 5 cents per ton under the lease, it did not do so during the years at issue (J.A. 24a, 33a, 54a).

[4] This clause had been added to the County's leases in the early 1950's to counter charges that the County Commissioners had granted leases on the basis of politics. The Court of Claims found that the Northumberland County Commissioners had publicly announced that they would not terminate a mining lease except for cause because of the time and capital which a lessee would be expected to invest in mining operations. However, the Commissioners continued to retain the power to cancel a lease without cause and they would give no assurance that they could not so cancel a lease (J.A. 54a).

b. *Black Hawk Coal Corporation.* During 1970–1972, respondent Black Hawk Coal Corporation was engaged in the mining of coal on lands located in Pike County, Kentucky. The lands in question were under a lease agreement dated February 20, 1964, between Kentland Coal & Coke Company, Division of the Berwind-White Coal Mining Company, as lessor, and Eugene M. Bane, as lessee. Bane in turn assigned the lease to Black Hawk (J.A. 69a).

Pursuant to the terms of the lease agreement, Black Hawk, as lessee, was authorized to remove coal from specified lands for an unspecified term until the coal seam was exhausted, for a consideration of $5,000 per year, payable monthly, or a royalty of 25 cents per ton of coal removed, whichever was greater. The latter amount was to be credited against the monthly royalty as rental (J.A. 70a–76a, 77a–78a). The agreement permitted respondent to sell the coal which it mined to anyone. The lease agreement was terminable if Black Hawk failed to pay the required rent or royalties for a period of 60 days after the due date of such payments, of if the lease agreement or the rights subject to that agreement were assigned, levied upon, or sold without the lessor's consent under any legal proceeding, or under any adjudication of Black Hawk's bankruptcy (J.A. 80a). Finally, the lease was cancellable by either party without cause on 30 days' written notice (J.A. 85a). On its federal income tax returns for 1970–1972, Black Hawk claimed a percentage depletion deduction with respect to the coal which had been mined under the lease agreement (J.A. 71a).[5]

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[5] Black Hawk hired independent contractors to engage in drift mining operations on the leased land. Drift mining is an underground mining process in which a horizontal coal seam is reached by clearing away part of the mountainside by bulldozer, after which two parallel tunnels are made into the coal seam. One tunnel is used for working

c. *Bull Run Mining Co.* During its taxable year ended September 30, 1974, respondent Bull Run Mining Co., Inc., was engaged in mining coal in West Virginia, under a lease agreement, dated June 21, 1967, between it, as lessee, and Preston County Coal and Coke Corporation, as lessor (J.A. 90a). The lease was for a five-year term, which was thereafter extended for an additional five years. Pursuant to the terms of the lease, Bull Run was authorized to mine coal on specified lands for the payment of a monthly royalty of 25 cents per ton of coal removed. The lease agreement was cancellable by either party on 30 days' written notice (J.A. 94a-95a). The lease gave the lessor the first opportunity to buy the coal mined by Bull Run only if the lessor met Bull Run's price (Pet. App. 4a n.4). On its federal income tax return for its taxable year ended September 30, 1974, Bull Run claimed a depletion deduction of $39,981.41 with respect to the coal which it mined as lessee under the agreement (J.A. 92a-93a).

2. On audit of each of respondents, the Commissioner of Internal Revenue determined deficiencies in income taxes on the ground that none of them possessed a depletable economic interest in the minerals covered by their leases. The Commissioner therefore disallowed respondents' claimed depletion deductions for the taxable years at issue. After respondents paid the resulting assessments, they filed claims for refund, which the Commissioner denied. Respondents thereupon instituted these refund suits in the Court of Claims (Pet. App. 3a).

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space in the removal of the coal while the other is used for ventilation. Coal is removed as the drift mine is driven into the mountain, following the coal seam. The roof is supported by pillars of coal in place and by erected wood supports. Black Hawk paid the hired contractor who removed the coal on a fixed-dollar basis per ton. The contractors transported the coal to a tipple, where the coal was cleaned. The tipple operator purchased the coal from Black Hawk on a per-ton basis at the time of delivery (J.A. 70a).

Finding that "the cases are legally all the same" (Pet. App. 4a; footnote omitted), the Court of Claims consolidated all three cases for argument. It upheld respondents' claims for refund on the authority of its prior decision in *Bakertown Coal Co.* v. *United States*, 485 F.2d 633 (1973). There, on virtually identical facts, a divided en banc court held that lessees under comparable coal leases had an economic interest in the coal in place, thereby entitling them to the percentage depletion deduction for the coal mined. The Court of Claims adhered to its *Bakertown* decision, ruling that the fact that the lessors could have terminated the lease without cause did not deprive respondent lessees of an economic interest in the minerals in place and the depletion deduction (Pet. App. 1a–10a). As the court saw the matter, "the mere existence of the unused termination clause is not enough to deprive the taxpayer-lessees of their 'economic interest' they would otherwise admittedly have" (Pet. App. 5a). In so holding, the court acknowledged that its decision squarely conflicted with *Whitmer* v. *Commissioner*, 443 F.2d 170 (3d Cir. 1971) (Pet. App. 5a–6a).

The Court of Claims further observed that even on the assumption that the lessor's legal right to terminate the lease (rather than whether there was an actual termination) was determinative of the lessee's eligibility to the depletion deduction, it "[could] not say *a priori* [in the absence of any proof] that a month's period is too short for a miner to expect to extract a substantial amount of coal" (Pet. App. 8a). In considering the effect of a termination clause, the court therefore concluded that "[l]ike *Bakertown*, these cases do not involve leases terminable within a single day" (*ibid.*).

Finally, as in *Bakertown* (see 485 F.2d at 642), the Court of Claims believed that if respondents' claimed de-

pletion deductions were disallowed, there would be no depletion on the coal mined under these leases. Although the court acknowledged the correctness of the government's argument that every applicant for the depletion allowance must show his own entitlement, it nevertheless concluded "that Congress, in establishing percentage depletion, intended that, except for extraordinary instances, someone should be entitled to depletion on all mined coal covered by the Code provision. *Cf.* I.R.C. § 613(c)" (Pet. App. 9a). As the court concluded, "[w]here there can be no other claimant, we believe that neither the Internal Revenue Service nor the courts should be too technical or too harsh in finding the only possible applicant to be ineligible. The considerations are in some (though of course not all) respects different from the cases in which a choice has to be made among competing claimants" (*ibid.*).

SUMMARY OF ARGUMENT

1. The decisions of this Court involving eligibility for the depletion allowance uniformly require that the taxpayer establish the equivalent of an ownership interest in the minerals in place. The depletion allowance "is permitted in recognition of the fact that the mineral deposits are wasting assets and is intended as compensation to the owner for the part used up in production." *Helvering* v. *Bankline Oil Co.*, 303 U.S. 362, 366 (1938). Hence, the deduction is "designed to permit a recoupment of the owner's capital investment in the minerals so that when the minerals are exhausted, the owner's capital is unimpaired." *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308, 312 (1956).

Two decisions of this Court—*Parsons* v. *Smith*, 359 U.S. 215 (1959), and *Paragon Jewel Coal Co.* v. *Com-*

missioner, 380 U.S. 624 (1965)—establish the correctness of the rule that we urge here, *viz.*, that a mineral lessee does not have a depletable capital investment in minerals in place if the lessor can terminate the lease on short notice without cause. In both of those cases, the Court emphasized the fact that the lessor had the right to so terminate the lease. While the decisions in *Parsons* and *Paragon Jewel Coal Co.* held that the lessees' obligation to deliver the coal at a fixed price deprived them of an economic interest in the coal in place, that fact does not diminish the significance of the lessors' right to terminate on short notice or the force of the Court's analysis as applied to these cases.

The ultimate question to be addressed here is which party has a capital investment in the minerals in place. Thus, the lessor's right to terminate on short notice without cause is simply one of many factors that deprive the lessee of a depletable capital investment in minerals in place in the same fashion as the lessee's obligation to deliver the minerals to the lessor at a fixed price. In the latter case, *Parsons* and *Paragon Jewel Coal Co.* hold that the lessee is nothing more than a contractor who cannot benefit from a rise in the market. His interest is an economic advantage rather than an economic interest in minerals in place.

But contrary to the reasoning of the Court of Claims in the instant cases, the lessee subject to termination on short notice is in an equally tenuous position vis-a-vis the minerals in place. Although he has a potential right to benefit from a rise in the market, that right is illusory for if the market rises above the lessor's royalty, the lessor can always exercise his right to terminate the lease on short notice, and either enter into a more profitable lease or extract the mineral himself and sell it. The terminabil-

ity on short notice provision therefore gives the lessor the unilateral right to assume complete and unfettered dominion over the mineral deposit. "Such right on the part of the lessor to terminate would appear to be fatal to a lessee's ability to claim the depletion deduction because no right to extract until exhaustion of the coal has been granted." *Whitmer* v. *Commissioner*, 443 F.2d 170, 173 (3d Cir. 1971).

2. There is, moreover, no basis for the Court of Claim's conclusion that if respondents are not entitled to the depletion deduction, "there will be no depletion on the coal mined under these leases" (Pet. App. 9a). The court apparently believed this conclusion to follow from the fact that under Section 631(c) of the 1954 Code, the lessors receive capital gains treatment on the royalties received. But the capital gains treatment to which the lessors would be entitled under Section 631(c) does not deprive them of the benefits of depletion. To the contrary, its applicability insures the lessors' eligibility for depletion. The special capital gains rule of Section 631(c) applies only when the "owner retains an economic interest in such coal * * *." In these circumstances, the owner fully recoups his capital investment in the minerals and thereby obtains the benefits of depletion under the cost depletion method (Section 612) by measuring his gain by "the difference between the amount realized from the disposal of such coal * * * and the adjusted depletion basis thereof." Accordingly, it is the lessors and not respondent-lessees who are entitled to the depletion deductions at issue here.

ARGUMENT

A MINERAL LESSEE HAS NO INTEREST IN THE MINERALS IN PLACE AND IS THEREFORE NOT ELIGIBLE FOR THE DEPLETION DEDUCTION IF THE LESSOR CAN TERMINATE THE LEASE ON 30 DAYS' NOTICE WITHOUT CAUSE

A. Qualification for the Depletion Deduction Requires a Capital Investment in the Minerals in Place

Section 611(a) of the Internal Revenue Code of 1954 (Appendix, *infra*, 1a) provides that "[i]n the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion * * * according to the peculiar conditions in each case * * *."[6] As this Court has declared on several occasions, the depletion allowance "is permitted in recognition of the fact that the mineral deposits are wasting assets and is intended as compensation to the owner for the part used up in production." *Helvering* v. *Bankline Oil Co.*, 303 U.S. 362, 366 (1938), quoted in *Parsons* v. *Smith*, 359 U.S. 215, 220 (1959). Thus, the deduction is "designed to permit a recoupment of the owner's capital investment in the minerals so that when the minerals are exhausted, the owner's capi-

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[6] Pursuant to Treasury Regulations on Income Tax, Section 1.611-1(a)(1) (26 C.F.R.) (Appendix, *infra*, 1a-2a), a taxpayer is authorized to calculate his depletion deduction on the basis of his cost (Section 612) or on the basis of a specified percentage of the gross income from the property (Section 613), whichever results in the greater allowance for any taxable year. Section 613(b)(4) of the Code provides that taxpayers may claim percentage depletion deductions with respect to coal equal to 10% of the "gross income from the property." Such depletion deductions may, in no event, exceed 50% of "the taxpayer's taxable income from the property (computed without allowance for depletion)." Section 613(a) of the Code.

tal is unimpaired." *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308, 312 (1956). "In short, the purpose of the depletion deduction is to permit the owner of a capital interest in mineral in place to make a tax-free recovery of that depleting capital asset." *Parsons* v. *Smith*, *supra*, 359 U.S. at 220. Accord: *Paragon Jewel Coal Co.* v. *Commissioner*, 380 U.S. 624, 631 (1965); *Anderson* v. *Helvering*, 310 U.S. 404, 408 (1940); *Kirby Petroleum Co.* v. *Commissioner*, 326 U.S. 599, 603 (1946).

From its very inception in the Revenue Act of 1918, qualification for the depletion deduction has required a capital investment in the minerals in place. Although the theory underlying the deduction is to permit a tax-free restoration of the owner's investment in a wasting asset, the statute has generally accorded the owner much more than a recovery of his actual out-of-pocket investment in the minerals in place. For example, under the Revenue Act of 1918 the "capital" that such an owner was permitted to recover by depletion was not limited to his own investment in the minerals in place but rather was the "fair market value of the property at the date" that the mineral deposits were "discovered."[7] See Revenue Act of 1918, ch. 18, Sections 214(a)(10), 234(a)(9), 40 Stat. 1068, 1078. As a result, depletion at the outset was computed by reference to an "investment" that was "stepped up" from the owner's actual capitalized outlays.[8]

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[7] The 1918 Act further provided that the depletion allowance with respect to mineral deposits discovered prior to March 1, 1913, should be computed on the basis of the property's fair market value as of that date (the date the Sixteenth Amendment to the Constitution, permitting imposition of an income tax, was ratified). See Section 214(a)(10) of the Revenue Act of 1918, ch. 18, 40 Stat. 1068.

[8] This method of computing allowable depletion deductions was apparently designed to foster three principal goals: "to encourage the discovery and development of new resources; to provide some measure

The computation of depletion allowances on the basis of "discovery" values proved impracticable and was soon replaced by the more administrable percentage depletion methods that have, in large measure, survived to the present statute. See Revenue Act of 1926, ch. 27, Section 204(c), 44 Stat. 9. But this change in the method of calculating depletion deductions did not represent a shift in the theory underlying the depletion allowance. To the contrary, the change was designed only to render the computation of those allowances more certain. As this Court recognized in *Helvering* v. *Bankline Oil Co.*, *supra*, 303 U.S. at 366–367 (emphasis supplied):

> In order to determine whether respondent is entitled to depletion with respect to the production in question, we must recur to the fundamental purposes of the statutory allowance. The deduction is permitted as an act of grace. It is permitted in recognition of the fact that the mineral deposits are wasting assets and is intended as compensation to the owner for the part used up in production. *United States* v. *Ludey*, 274 U.S. 295, 302. *The granting of an arbitrary deduction, in the case of oil and gas wells, of a percentage of gross income was in the interest of convenience and in no way altered the fundamental theory of the allowance.*

See also *Usibelli* v. *Commissioner*, 229 F.2d 539 (9th Cir. 1955). Qualification for the depletion deduction thus continues to require that the claiming party possess an interest in the entire mineral deposit.[9]

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of equality between producers whose discoveries were [made] afterward; and to 'equalize' the tax treatment of those who operated their own discoveries and those who purchased proven areas." Sneed, "*The Economic Interest*," 35 Tex. L. Rev. 314 (1957), and authorities cited therein.

[9] For example, every taxpayer claiming a depletion of allowance is required to make a cost depletion calculation. *Producers Oil Corp.* v. *Commissioner*, 43 B.T.A. 9 (1940). He must estimate the total mineral reserves and determine the percentage of mineral reserves removed

The decisions of this Court involving eligibility for the depletion allowance uniformly require that the taxpayer establish the equivalent of an ownership interest in the minerals in place. In response to the variety of financial arrangements employed in the extraction of minerals, this Court almost 50 years ago in *Palmer* v. *Bender*, 287 U.S. 551 (1933), developed the "economic interest" test for determining what interests in mineral deposits were permitted a depletion deduction under the practically identical statutory predecessors of Sections 611 and 613. As the Court there stated (287 U.S. at 557), "[t]he language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital." The Court further said that the depletion deduction is not "dependent upon the particular legal form of the taxpayer's interest in the property to be depleted, [and that] [it] is enough if * * * he has an *economic interest* in the oil, in place, which is depleted by production" (287 U.S. at 557; emphasis added). Accord: Treasury Regulations on Income Tax, Section 1.611-1(b)(1) (26 C.F.R.), Appendix, *infra*, 2a.

Thus, in *Palmer* v. *Bender*, *supra*, the Court upheld a depletion deduction claimed by lessees who acquired complete legal control of the oil in place and subsequently transferred their operating interests to a third party in

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and sold during the taxable year in order to calculate the amount of cost depletion deductions allowable for that year. The taxpayer's cost is then divided by his estimated reserves in the mineral and multiplied by the number of units of such mineral sold in the taxable year. See Treasury Regulations on Income Tax, Section 1.611-2(a) (26 C.F.R.). This calculation rests upon the understanding that in calculating his depletable interest, the taxpayer must look to the entire mineral interest.

exchange for a royalty or bonus from oil to be produced. In so ruling, the Court rejected the argument that the transactions were outright sales of the leases for the stipulated consideration of bonus paid and royalties to be received so that the only deduction allowable to the lessees was their cost of the properties. As the Court analyzed the arrangements, "[W]hen the two lessees transferred their operating rights to the two oil companies, whether they became technical sublessors or not, they retained, by their stipulations for royalties, an economic interest in the oil in place, identical with that of a lessor" (287 U.S. at 558).

Subsequently, in *Helvering* v. *Bankline Oil Co.*, *supra*, 303 U.S. at 367, the Court elaborated on the "economic interest" concept. It observed that "* * * the phrase 'economic interest' is not to be taken as embracing a mere economic advantage derived from production, through a contractual relation to the owner, by one who has no capital investment in the mineral deposit." See Treasury Regulations, Section 1.611-1(b)(1), Appendix, *infra*, 2a. Applying this principle to the facts of that case, the Court held that a processor who acquired the right to take wet gas from the wellheads and to extract and sell gasoline therefrom, paying the owners a percentage of the proceeds of such sales, had acquired an economic advantage, but not an economic interest in the gas in place even though the processor's profits in some instances were determined solely by reference to the sales price of the gasoline and the natural gas.

The foregoing authorities therefore establish beyond question that eligibility for the depletion deduction requires much more than simply the receipt of income derived from the extraction or sale of minerals. If the rule were otherwise, an oil drill operator, a public utility selling natural gas to customers, or the owner of a gasoline

service station could claim the deduction. But such is not the case. The relationship of such persons to the particular minerals is one of economic advantage, *viz.*, the opportunity to perform services in the extraction process or to sell minerals at a profit. However, the depletion deduction is premised on the theory that it affords a tax-free recovery of the impairment of capital resulting from exhaustion of the mineral deposit. Hence, the claimant to the deduction must have a capital investment in the minerals in place which diminishes in value as a consequence of the extraction process.

We submit that a mineral lessee has no capital investment in the minerals in place and is therefore not eligible for the depletion deduction if the lessor can terminate the lease on 30 days' notice without cause. In such circumstances, the lessee is a mere tenant at will whose interest is entirely subject to the whim of the lessor who can force him to abandon the venture on short notice. How can it be said that the lessee has a capital investment in the minerals in place if his right to extract the minerals is subject to a contingency totally beyond his control?

It is therefore hardly surprising that two decisions of this Court employing the economic interest test have emphasized that a lessor's unqualified right to terminate a lease on short notice without cause deprives the lessee of any capital investment in the minerals in place that would support a claimed depletion deduction. *Parsons* v. *Smith*, 359 U.S. 215 (1959); *Paragon Jewel Coal Co.* v. *Commissioner*, 380 U.S. 624 (1965). The Court's analysis in these cases confirms the correctness of the proposition that a mineral lessee cannot claim the depletion deduction if the lessor can terminate the lease on short notice without cause. We therefore turn to a detailed discussion of both *Parsons* and *Paragon Jewel Coal Co.* to show why their

reasoning is fully applicable here and requires reversal of the decision below.

B. A Mineral Lessee Does Not Have a Depletable Capital Investment in Minerals in Place if the Lessor can Terminate the Lease on Short Notice Without Cause

1. In *Parsons* v. *Smith*, 359 U.S. 215 (1959), this Court affirmed two decisions of the Third Circuit (255 F.2d 595 (1958); *id.* at 597) disallowing mineral lessees' claimed depletion deductions where "the contracts were completely terminable without cause on short notice" (359 U.S. at 225). There, the taxpayers had leased coal-bearing land; they agreed to strip mine the tract, and to deliver the coal to the lessors in exchange for a fixed tonnage price. Both lessees provided the labor and equipment which involved substantial cash outlays. In ruling that the lessees did not qualify for the depletion deduction, the Court rejected their argument that "by their contracts to mine the coal, and particularly by contributing their equipment, organizations and skills to the mining project as required by those contracts, they, in legal effect, made a capital investment in, and thereby acquired an economic interest in, the coal in place * * *" (*id.* at 223-224). As the Court saw the matter, "[b]y their contracts, which were completely terminable without cause on short notice, [the lessees] simply agreed to provide the equipment and do the work required to strip mine coal from designated lands of the landowners and to deliver the coal to the latter * * * [for] a fixed sum per ton" (*id.* at 224).

In *Paragon Jewel Coal Co.* v. *Commissioner*, *supra*, the Court likewise reaffirmed that mineral lessees whose interests under the lease are subject to termination on short notice without cause did not have a depletable capi-

tal investment in the minerals in place. There, a number of contractors had agreed with Paragon, which had leased certain coal properties, to extract coal by the drift mining method at their own expense and to deliver it to Paragon for a fixed price per ton. Although the contracts were silent with respect to termination and were apparently to run for an indefinite period, the contractors were under no obligation to mine a specific amount of coal and were not given the right to mine any particular area to exhaustion. In fact, many of the contractors quit mining when it suited them.

Although the leases in *Paragon Jewel Coal Co.* did not specifically empower the lessor to terminate on short notice, the Court found that as a practical matter the lessor had such a right. The Court premised its construction of the lease on the facts that " 'the contracts did not fix upon the operators an *obligation* to mine to exhaustion' " and that "many of them quit at any time they chose" (380 U.S. at 634; emphasis in original). Given the right to terminate on the part of the contractors, the Court found a corresponding right on the part of the lessor. As the Court observed, "[W]e are unable to say that it is any more inequitable to allow Paragon to terminate the contracts at will than it is to allow the contractors to terminate work and thereby impose upon Paragon the obligation to get other people to work the mine or forfeit its right under the leases" (*ibid.*).

To be sure, the decision in *Paragon Jewel Coal Co.* did not turn on the basis of the Court's construction of the lease as containing a right to terminate on the part of the lessor. Rather, the Court ultimately concluded that the contractors had no depletable capital investment in the coal in place because Paragon was bound to pay a fixed price for the coal regardless of the market conditions at

the time of delivery. In these circumstances, the contractors has no depletable economic interest in the coal in place because they "did not look to the sale of the coal for a return of their investment, but looked solely to Paragon to abide by its covenant" (380 U.S. at 635).

But the fact that the lessees in *Parsons* and *Paragon Jewel Coal Co.* agreed to deliver the coal for a fixed price does not diminish the significance of the lessor's right to terminate on short notice. The ultimate question to be addressed in these cases is which party has a capital investment in the minerals in place. Thus, the fact that in the instant cases, respondents had the right to sell the coal at any price the market would bear does not automatically establish that they had a depletable capital investment in the coal in place as opposed to a more economic advantage akin to that of a wholesaler or distributor. As this Court observed in *Helvering* v. *Bankline Oil Co.*, *supra*, 303 U.S. at 368, "[W]hether or not the wet gas had a market value and, if it had, whether that value was greater than the amount respondent paid, is in no sense determinative. Respondent was still a processor, paying for what it received at the well's mouth."

Given the lessors' right to terminate the leases on 30 days' notice, without cause, it is difficult to imagine what kind of "economic interest" respondents could be said to have acquired in the minerals in place. Respondents' right to mine the coal was completely subject to the will of their lessors who could have forced them to abandon their ventures on short notice if the lessors found the leases to be unprofitable or disadvantageous in light of changing market conditions. In these circumstances, it is the lessors who have the economic interest in the coal in place and respondents cannot claim a right to exhaust either the entire coal deposits or any particular substantial part of it.

In short, the lessor's right to terminate on short notice without cause is simply another factor that deprives the lessee of a depletable capital investment in the minerals in place in the same fashion as the lessee's obligation to deliver the minerals to the lessor at a fixed price. In the latter case, *Parsons* and *Paragon Jewel Coal Co.* hold that the lessee is nothing more than a contractor who cannot benefit from a rise in the market. His interest is an economic advantage rather than an economic interest in minerals in place.

But contrary to the reasoning of the Court of Claims in the instant cases, the lessee subject to termination on short notice is in an equally tenuous position vis-a-vis the minerals in place. Although he has a potential right to benefit from a rise in the market, that right is illusory for practical economics will compel the lessor to terminate the lease and conclude a more favorable arrangement if market conditions so dictate. As the Third Circuit observed in *Whitmer* v. *Commissioner*, 443 F.2d 170, 173 (1971), "[s]uch right on the part of the lessor to terminate would appear to be fatal to a lessee's ability to claim the depletion deduction because no right to extract until exhaustion of the coal has been granted." Accord: *Costantino* v. *Commissioner*, 445 F.2d 405, 409 (3d Cir. 1971) (30-day termination); *Mullins* v. *Commissioner*, 48 T.C. 571 (1967) (60-day termination); *Winters Coal Co.* v. *Commissioner*, 57 T.C. 249 (1971) (30 and 60-day termination), rev'd on other grounds, 496 F.2d 995 (5th Cir. 1974); *Holbrook* v. *Commissioner*, 65 T.C. 415 (1975) (30-day termination); *Weaver* v. *Commissioner*, 72 T.C. 594, 606-609 (1979) (immediate termination); G.C.M. 26290, 1950-1 Cum. Bull. 42, declared obsolete, Rev. Rul. 70-277, 1970-1 Cum. Bull. 280.

2. In light of the foregoing, we submit that the decision of the Court of Claims in the instant cases and in *Baker-*

town Coal Co. v. *United States*, 485 F.2d 633, 640-641 (1973), to which it adhered (Pet. App. 5a), reflects a fundamental misconception of this Court's "economic interest" test. In *Bakertown Coal Co.*, the Court of Claims acknowledged that this Court in *Parsons* v. *Smith*, *supra*, accorded significant weight to the lessor's right to terminate on short notice without cause in ruling that the lessee was thereby deprived of an economic interest in the minerals in place. However, the Court of Claims refused to ascribe controlling weight to the lessor's right to terminate at will. In its view, "[t]hough terminability was one of the seven disqualifying factors mentioned [in *Parsons* v. *Smith*, *supra*], it cannot be considered either in isolation or in the abstract, as the Government would have it" (485 F.2d at 639). The Court of Claims concluded that "the matter of terminability becomes only a colorably relevant factor where the applicant for the allowance lacks the traditional qualifications for depletion, as reflected by the other six conditions referenced by the court" (*ibid.*).[10] The

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[10] In *Parsons* v. *Smith*, *supra*, 359 U.S. at 215, the Court enumerated seven factors in support of its decision rejecting mining contractors' claims to depletion deductions, as follows (*id.* at 225; emphasis supplied):

> (1) that petitioners' investments were in their equipment, all of which was movable—not in the coal in place; (2) that their investments in equipment were recoverable through depreciation—not depletion; (3) *that the contracts were completely terminable without cause on short notice;* (4) that the landowners did not agree to surrender and did not actually surrender to petitioners any capital interest in the coal in place; (5) that the coal at all times, even after it was mined, belonged entirely to the landowners, and that petitioners could not sell or keep any of it but were required to deliver all that they mined to the landowners; (6) that petitioners were not to have any part of the proceeds of the sale of the coal, but, on the contrary, they were to be paid a fixed sum for each ton mined and delivered, which was, as stated in *Huss*, agreed to be in "full compensation for the full performance of all work and for the furnishing of all

Court of Claims therefore distinguished *Parsons* v. *Smith*, *supra*, on the ground that there "the coal company was bound to pay the contractors the posted fee regardless of the condition of the market at the time of delivery and, thus, that the contractors did not look to the sale of the coal for a return of their investment but looked solely to the coal company" (485 F.2d at 640).

To be sure, the Court of Claims correctly concluded that the mining contractors in *Parsons* v. *Smith*, *supra*, "were equally deficient under each of the six other criteria set forth by the Supreme Court" (485 F.2d at 639). See also *Paragon Jewel Coal Co.* v. *Commissioner*, *supra*; *United States* v. *Stallard*, 273 F.2d 847 (4th Cir. 1959); *McCall* v. *Commissioner*, 312 F.2d 699 (4th Cir. 1963). But this purported distinction, upon which respondents rely as well (Br. in Opp. 16), ignores this Court's admonition, made in the context of another depletion case, that "the tax law deals in economic realities, not legal abstractions." *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308, 315 (1956). As we have pointed out (*supra*, page 19), if the market price of the minerals rises above the lessor's royalty, the lessor will assuredly exercise his right to terminate the lease on short notice and will either enter into a more profitable lease or extract the mineral himself and sell it. In these circumstances, the lease provision permitting termination on short notice[11] gives the lessor the uni-

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[labor] and equipment required for the work"; and (7) that petitioners, thus, agreed to look only to the landowners for all sums to become due them under their contracts.

[11] The Court of Claims also held that, even if the lessor's right to terminate the lease were determinative, the court could not say, in the absence of proof, that 30 days was too short a period for the lessee to extract a substantial amount of coal (Pet. App. 8a). But these refund suits are analogous to an action for money had and received. Hence, respondents bore the burden of proof that they overpaid their taxes and were entitled to a refund of a particular amount. *Lewis* v.

lateral right to assume complete and unfettered dominion over the mineral deposit, *viz.*, an economic interest in the minerals in place. The unexercised termination clause therefore has profound economic significance, rather than, as the decision below erroneously concluded (Pet. App. 5a), "mere existence."[12] Accord: *United States* v. *Stallard*, 273 F.2d 847 (4th Cir. 1959); *McCall* v. *Commissioner*, 312 F.2d 699 (4th Cir. 1963); *United States* v. *Wade*, 381 F.2d 345 (5th Cir. 1967). See also *Ramey* v. *Commissioner*, 47 T.C. 363, 375 (1967), aff'd, 398 F.2d 478 (6th Cir. 1968); *Usibelli* v. *Commissioner*, 229 F.2d 539 (9th Cir. 1955); *Rissler & McMurry Co.*, 480 F.2d 684 (10th Cir. 1973).

3. Finally, there is no basis for the Court of Claims' observation, made both in the instant case (Pet. App. 9a) and in *Bakertown Coal Co.* v. *United States*, *supra*, 485 F.2d at 642, which respondents invoke as well (Br. in Opp. 20–22), that if respondents are not entitled to the depletion deduction, "there will be no depletion on the coal mined under these leases" (Pet. App. 9a). The court apparently believed this conclusion to follow from the fact that "[u]nder the express terms of Section 631(c) of the 1954 Code, the lessors are 'relegated to capital gains treatment of the royalties received,' *Paragon Jewel Coal*

Reynolds, 284 U.S. 281 (1932). The absence of proof should therefore redound to respondents' detriment, and not to the government's. At all events, the question is not whether respondents could extract a substantial amount of coal in 30 days, but whether they could extract a substantial portion of the deposits in that period. See G.C.M. 26290, *supra*.

[12] This Court's emphasis in *Parsons* v. *Smith*, *supra*, upon the lessor's right to terminate on short notice without cause is at sharp variance with the view of the dissenting judge in the court of appeals in that case (upon that court's denial of rehearing en banc) that the "right of termination does not affect a stripper's right to depletion where the requisite economic interest as defined by the Supreme Court exists" (*Huss* v. *Smith*, 255 F.2d 599, 602 (3d Cir. 1958)).

Co. v. *Commissioner, supra*, 380 U.S. at 636 * * *" (485 F.2d at 642).

But the capital gains treatment to which the lessors would be entitled under Section 631(c) does not deprive them of the benefits of depletion, which "is designed to permit a recoupment of the owner's capital investment in the minerals so that when the minerals are exhausted, the owner's capital is unimpaired." *Commissioner* v. *Southwest Exploration Co., supra*, 350 U.S. at 312. The special capital gains rule of Section 631(c) applies only when the "owner retains an economic interest in such coal * * *." In these circumstances, the owner fully recoups his capital investment in the minerals and thereby obtains the benefits of depletion by measuring his gain by "the difference between the amount realized from the disposal of such coal * * * and the adjusted depletion basis thereof * * *." While the lessor will not ratably recover his basis through percentage depletion, the subtraction of his adjusted depletion basis in measuring his gain insures that he will "make a tax-free recovery of that depleting capital asset" (*Parsons* v. *Smith, supra*, 359 U.S. at 220) under the cost depletion method (Section 612). See *Herring* v. *Commissioner*, 293 U.S. 322, 327-328 (1934).[13] Accordingly, the lessor's right to terminate on short notice without cause requires the conclusion that the lessors, and not respondents-lessees, have the requisite economic interest in the coal in place and are therefore entitled to the depletion deductions at issue here.

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[13] In these circumstances, the lessor can claim both cost depletion and capital gains treatment under Section 631(c). Where Section 631(c) is inapplicable, the lessor can claim percentage depletion but must report his receipts as ordinary income. *Burnet* v. *Harmel*, 287 U.S. 103 (1932).

CONCLUSION

For the reasons stated, the judgments of the Court of Claims should be reversed.

Respectfully submitted.

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APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 611. Allowance of deduction for depletion

(a) *General Rule*—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary. * * *

* * * * *

SEC. 613. Percentage depletion

(a) *General Rule*—In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). * * * In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.

* * * * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.611-1. Allowance of deduction for depletion.

(a) *Depletion of mines, oil and gas wells, other natural deposits, and timber*—(1) *In general.* Section 611 provides that there shall be allowed as a deduction in computing taxable income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion. * * * In the case of other exhaustible natural resources the allowance

for depletion shall be computed upon either the adjusted depletion basis of the property (see section 612, relating to cost depletion) or upon a percentage of gross income from the property (see section 613, relating to percentage depletion), whichever results in the greater allowance for depletion for any taxable year. In no case will depletion based upon discovery value be allowed.

* * * * *

(b) *Economic interest.* (1) Annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits or standing timber. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital. For an exception in the case of certain mineral production payments, see section 636 and the regulations thereunder. A person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because through a contractual relation he possesses a mere economic or pecuniary advantage derived from production. For example, an agreement between the owner of an economic interest and another entitling the latter to purchase or process the product upon production or entitling the latter to compensation for extraction or cutting does not convey a depletable economic interest. Further, depletion deductions with respect to an economic interest of a corporation are allowed to the corporation and not to its shareholders.

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